

HELP ?

Saudi Arabia and the GCC: Exploring for growth in a troubled global economy

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Abstract:

The attempts of Saudi Arabia and the Arabian Gulf Cooperation Council to cope with low oil prices and diminished prospects for several of the world's most important economic regions are discussed.

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Separately and together, the Arabian Gulf Cooperation Council (GCC) countries - Saudi Arabia, the United Arab Emirates (UAE), Kuwait, Oman, Qatar and Bahrain - are considering how to cope with low oil prices and diminished prospects for several of the world's most important economic regions. Even before the downturn, the Arabian Peninsula countries were having to face a lengthening list of internal challenges: pressing needs to reduce reliance on oil, accelerate the development of private sector industries and services, expand infrastructure, make leaps in business productivity, and expand employment opportunities for citizens.

How the world community will respond to the challenges posed by regional weakness will make a great deal of difference to the Gulf. Whether the Gulf is included in the processes that are now being crafted to make this response will affect the extent of the Gulf's participation in solutions. For now, the Gulf's role has been marginalized. In spite of Saudi Arabia's presence as a full executive director of the International Monetary Fund, it has been excluded from a seat on the Basle Committee's G-22, the new emerging-markets club. This is particularly important now because in Saudi Arabia and the other Gulf countries, businessmen and government officials are in the process of choosing between two distinctly different paths for future economic development: the closed and the open.

The closed path promises continuity to the past, to the systems that were established during the booms when oil shortages and petrodollars would attract foreign trade and investment despite the array of privileges and preferences enjoyed by locals. While oil is now less important and the froth of oil money has long since subsided, there are still accumulations of private and official wealth to cushion against some pressures, and many of the jobs once held by expatriates can be given to nationals. Against the hope that oil prices will rise again some day, this approach would parcel out shares of an, at best, slowly growing economic pie across rapidly growing national populations.

The open path would bring new elements into the equation, including much larger roles for new generations of both local and foreign private entrepreneurs and investors. The aim would be to leverage upon past accomplishments and accumulated wealth in order to develop more rapidly the full spectrum

of new economic opportunities. Subsidized state utilities and protected local agencies would give way to privatizations, global networking and national treatment. The old notion of technology transfer, equipment that comes in a box, would be updated to embrace all varieties of productivity technologies. These are the management systems and information-handling techniques that make companies more efficient and competitive. Such "soft" technology is acquired only through associations with the world's most forward-thinking companies. Those companies, many small but growing, select where to go in view of how fairly they will be treated under national policies governing taxation, investment, intellectual property, trade and the resolution of disputes. If the national accounts lack timeliness or transparency, there are plenty of other places that want their business and investment. Down the open path for development these issues would be resolved through measures to level the playing field for foreign and domestic companies, or where cultural considerations predominate, through adaptations to build bridges - for example, between Islamic and Western legal systems. Perhaps greater use could be made of international treaty provisions for the arbitration of business disputes.

The globalization of media means that every fleck of bad news is now transmitted around the world at light speed, usually with only superficial analysis. In this environment, wiser minds will take stock of underlying strengths and sources of stability. It is such strengths, presumably, that represent the foundations for "the restoration of confidence ... the positive changes ... the improvements to the financial system ... and the new economic growth" that President Clinton called for in his September 14, 1998, address on how to respond to the regional weaknesses of Asia and Russia. Notwithstanding the day-to-day performance of the Dow or the DAX, the American and European economies continue to grow, washed by waves of real gains in the productivity of their businesses and workers. Welfare economics and overbearing government programs are things of the past. The PC and the Internet are here to stay. Japan's growth has faded, but its industriousness continues to generate remarkable surpluses. China's vast market continues to expand and open up. Not all, but many of the restructuring issues facing Korea's corporations and banks have been resolved and are in the process of implementation. A strong core of Thailand's business community survived the financial hurricane and is now finding new directions on much more realistic bases. Future reversals cannot be ruled out, but there are some positive indicators.

If all of the emerging market countries were ranked in terms of the financial, physical and human resources that they can bring to bear to meet their future economic challenges, the Gulf economies would appear near the top of the list. It is true that oil prices will likely average about one-third lower in 1998 than in 1997 (about \$12 as opposed to \$18 per barrel). For the Gulf countries, which together export around 12 million barrels per day, this represents roughly a \$25-billion drop in oil export revenues to just above \$50 billion for 1998. With the right policies, however, even the lower annual oil income could contribute substantially to the new foundations for growth. Any other region would gladly accept such a revenue stream.

In the Gulf, attitudes are already adjusting to view oil as part but not all of the foundation for future economic growth. After all, this is the third big downturn in oil prices since the booms of the 1970s and 80s. The region is the wiser, applying lessons from the past. In Saudi Arabia the responses to this year's oil-price downturn have been swift and comprehensive. The budget was trimmed and reprioritized to reduce foreign obligations, in particular for the expansion of (unneeded) surplus oil-production capacity and for military programs. New non-oil-revenue measures have been announced, and more are expected. Pledges have been followed by programs to keep government payments current, thus avoiding the burdening of company balance sheets with illiquid receivables. There are a variety of innovative financing measures, to include greater disbursements of special bonds to settle amounts owed to contractors and large new borrowings by Aramco. As the world's largest oil company, Aramco

enjoys favorable terms in widely subscribed international syndications. Taken altogether, such measures have cushioned the impact of the drop in oil prices on private businesses, leaving them in good condition to take on broader economic roles.

Let it not be forgotten that 1996 and 1997 were very good years for the Gulf. Oil prices were high, and the added revenues were well spent. The banks and businesses of the GCC region are in very good shape. Those were years when economic confidence led many companies to diversify into new businesses that do not depend on government contracts or oil. Such diversification is indicated by the fact that Saudi Arabia's GDP grew by \$20 billion from 1995 to 1997, from \$125 billion to \$145 billion. Its merchandise imports, however, were flat, a sign of rising economic self-reliance. That apparent economic diversification was supported by substantial capital inflows, both foreign capital coming into local markets and new projects and capital repatriated from abroad by local investors. The region's balance-of-payments current accounts were modestly in surplus, so these capital inflows contributed to substantial increases in the net foreign assets of the region's governments. As a result, the GCC countries are now in a very strong position to defend the stability of their currencies and to insure continued adequate liquidity to local banks and businesses. Saudi Arabia's government bonds continue to enjoy a zero-risk weighting under the Bank of International Settlements (BIS) Capital Adequacy Standards, the only non-OECD country to enjoy this status. The governments remain true to their conservative and prudent monetary policies. Inflation is simply not an issue. During 1997 Saudi Arabia's consumer price index actually fell by about .5 percent.

Unlike Asia, Eastern Europe or the CIS, the financial systems of the GCC are in good shape. Indeed banking, funded largely from growing local sources, remains a vibrant and growing business. Since the end of 1991 (the year of the Gulf War), the consolidated balance sheet of Saudi Arabia's banks has grown steadily, at an average annual rate of 6.2 percent, from about \$69 billion to \$105 billion. Balance sheets grew by about 6.6 percent in 1997 and a further 2.9 percent to mid-year 1998, in line with the long-term trend. Leading this growth was the expansion of bank capital accounts, which increased at an average annual rate of more than 14 percent. The BIS capital adequacy ratios of the Saudi banks as a group are upwards of 16 percent, more than twice the BIS minimums.

The banks' local customer deposits have grown since 1991 by an average of 4.4 percent per year. So far in 1998, deposits have grown more rapidly than the long-term trend, increasing by 3.1 percent during the first six months. As for foreign funding, the Saudi banks have a \$6.4 billion positive net due-from position with respect to placements with foreign banks. They also have large foreign-securities portfolios, which represent an important source of liquidity and strength. At mid-98, these portfolios totaled \$8.3 billion. Their total foreign assets stood at \$25 billion, or about 23 percent of total assets.

The stock markets of the GCC region present a mixed, but still quite interesting picture. The markets of Qatar and the UAE have offered new listings and sell-downs of government shares in national utilities to their many well-heeled local investors. Their all-share indexes are up strongly this year, by over 40 percent and 70 percent. These markets, however, are small and relatively undeveloped in terms of market infrastructure and regulation. Saudi Arabia, on the other hand, has a very large market, by far the largest in the Middle East, with a capitalization exceeding \$50 billion. When rated by a World Bank group, the Saudi market won high marks for its efficiency, transparency and quality of regulation. The Saudi market was recently included in the IFC Global Index. It lists some of the strongest companies and banks, not just in the region but in the world, to include the Saudi Arabian Basic Industries Corporation (SABIC), Saudi American Bank (SAMBA, a highly successful Citibank joint venture), and the joint-venture affiliates of HSBC, ABN-Amro, Credit Agricole and Arab Bank.

Worries over oil and Asia triggered a correction that dropped the local all-share index by 20 percent from its October 1997 peak, or by 13 percent, year to date. Since mid-year, the market has been stable, having settled at an over all price-to-earnings valuation level fractionally above twelve. Dividend yields are high, more than 4 percent for many of the banks, near 7 percent for SABIC, and over 11 percent for many of the cement companies. The drop in global petrochemical prices will shave SABIC earnings, but the company remains strongly profitable and will probably continue to pay larger dividends than its international competitors. The privatization of the national phone company and several new listings are in the pipeline. Except for investment by GCC individuals into selected shares and a single closed-ended country fund (the Saudi Arabia Investment Fund, which is managed by SAMBA), the Saudi market is largely closed to foreign investors. New measures to open the market are under review. Even small steps in that direction would buoy investor confidence. An even more aggressive opening could bring about the re-rating of the market, where investors came to evaluate share prices in terms of their relationship to earnings growth expectations, as opposed to the prevailing approach which focuses on dividend yields.

Oman experienced just such a re-rating after it opened its market to foreign portfolio investors a few years ago. That opening supported waves of new corporate listings and buoyed the local index to breathtakingly high levels in 1997. Developments in Asia, however, sucked liquidity out of the emerging markets generally. Oman was not immune; divestment by foreign shareholders has contributed to a more than 43 percent drop in the local index so far this year. It has also made the market more volatile, subject to daily swings as high as 5 percent. Beyond disappointing foreign portfolio holders, such developments have seriously disturbed both local investors and local business.

There are good reasons to feel that, like the Saudi market, Oman's market will recover. Analysts take heart in the country's good record for policy reform and its general resilience. However, its experience points to a real problem. The same policy prescriptions that the IMF had recommended to spur growth in Asia and Russia attract large volumes of hot money, funds that flee on a headline, often without appreciation for how companies will be affected. Indeed, recent conditions in Oman's market reflect more the global investors' attitudes toward Asia or Russia than any assessment of what is really happening in Oman. In very open but still small markets, the local investor is dwarfed. The ability of local companies to raise needed equity capital is held hostage to developments on the other side of the planet. In sum, the essential economic function of the stock market - to intermediate savings into investment - can be crippled.

What, then, can the GCC region contribute to help restore stability and growth in Asia and Russia? How will the prescriptions that are formulated to rebuild the troubled economies and prevent broader contagion affect the GCC? Because of what it has to offer to eventual solutions, and because of the lessons it has learned from its vantage point at the edge of the hurricane, it is desirable for the GCC to be directly represented in the processes that will craft these solutions. Whether it is included or remains marginalized also means much to the GCC itself. If included, it will be able to see much more clearly the potential advantages of pursuing its open development option. If excluded, the hand of those who want to keep the region closed will be strengthened.

The Gulf economies have already made substantial contributions to Asia's recovery. These have been in the form of drastically reduced oil prices and related import costs. The value of oil exports from the GCC region to the Far East for 1998 will be around \$15 billion lower than it was during 1997. Oil alone explains a substantial portion of the improvements seen this year in the current accounts of South Korea and Thailand, as well as Japan.

These contributions, however, were unwilling and unwanted. What the GCC wants and needs is to deepen and broaden its business ties around the world in ways that help to build economic opportunity at home, as well as profits abroad. To attract this new business, it has much to offer: large and growing domestic markets with still strong spending power. It has a good regional position that touches North Africa and the Mediterranean to the west, the Caspian to the north, and the Indian subcontinent to the east. It has growing local work forces and governments that are ready to invest billions for training and skill development. Its companies and banks are strong. They know their customers well, having had ample experience to find their true comparative advantages in areas where intimate knowledge of local market preferences and practices is crucial.

What the business leaders need are productivity technologies and windows on the world. They need the new business associations that will help them to take full advantage of what being a company in a WTO most-favored nation can mean. They also need to strike a new balance between the roles of government and the private sector in their own economies. Insofar as this involves finding a new relationship to foreign investors, they need to arrive at new formulas to handle greater amounts of both foreign direct and portfolio investment.

To date, the strong preference has been for direct investment. Having witnessed the collapses in more open emerging markets, it is not surprising that the Gulf feels somewhat vindicated in its approach. However, as Saudi Arabia has discovered, there are limits to how far direct investment can be developed in the absence of much broader participation from portfolio investors. This question of how to strike the right balance between policies governing direct and portfolio investment is exactly the same question that the IMF and other institutions will review as they try to formulate prescriptions to dampen hot money volatility and restore stable growth. Given its longstanding position as one of the IMF's permanent executive directors, it would seem both logical and desirable to include Saudi Arabia as a representative of the GCC within the new club of emerging markets. Saudi Arabia will participate in some of the G-22 working committees. Its role, however, should be more prominent.

The other reason to include Saudi Arabia pertains as much to other Arab and Islamic countries as it does to the Gulf. The foundations for future growth with stability must include improvements to the global legal infrastructure and to the accuracy and transparency of national, financial and corporate accounts. What is contemplated, quite clearly, is a more comprehensive and inclusive set of guidelines along with measures that urge, if not compel, countries to comply. It is intended that this approach should be broadly inclusive, to attract the widest possible participation from both developed and emerging-market economies.

However, if the GCC is not directly represented at the executive level in the process that will ratify these guidelines, there is a substantial and important risk that they could be viewed throughout the Islamic world as exclusive rather than inclusive. Clearly, for the guidelines to be broadly accepted, there must be consideration from the outset for how to bridge the gap between Western and Islamic legal systems.

The point on transparency is similar, although perhaps basically easier to address. There are differing views on who owns information and the role that ownership of information plays in governance and business relations. No doubt, to function efficiently markets need comprehensive, timely and true indications of the conditions of companies and the economy. However, the standards and forms for how that information is presented have developed along very different lines in the West than in the Arab world. That is not to say that the Arab world cannot meet the criteria; indeed, many are already

working hard to improve the coverage of their data and enforce internationally accepted audit principles. For certain categories, however, there appears to be need for compromises, for example, over the definitions behind what governments must show as their true reserves. After all, it is the open kimono policies of Asia that in part enable voracious hedge-fund speculators to assault not only individual country currencies, but also the coffers of the IMF and the lending nations that are committed to bailouts. Again, having direct participation from Saudi Arabia and the GCC should help to arrive at better compromises.

CONCLUSION

When viewed from Riyadh, it appears that both the world financial system and the future of the Gulf economies are at a crossroads. Coming from different directions perhaps, the global community and the Gulf countries are having to choose which paths to follow. There are great opportunities. The Gulf countries have much to contribute to final solutions, their capital, markets and unique understanding of the challenges of economic development. They also could take much away in the form of improved economic prospects, reduced reliance on oil, greater hope and opportunity to meet the expectations of rapidly growing and youthful populations. It will make a vast difference to solutions for the troubled regions whether the approach taken by global institutions is inclusive rather than exclusive in regard to Saudi Arabia and the Gulf. Likewise, whether the Gulf region is fully included at an appropriate senior level will have an impact on how it proceeds down the avenue for more open development and growth. There are many in the GCC who see their economic glass as half full and are ready to do the hard work and make the compromises that would fill it to the top. To involve these people directly and fully in the process that will address the regional troubles will strengthen their hand. If included in the process of finding solutions, they can also help to fill the half-empty glasses of others.

[Author note]

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